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This expansion has violated everything I know about the economy. Part of the explanation is we are doing so well because the rest of the world is doing poorly...inflation has been so good because commodity prices are depressed and everyone else has excess capacity. The fate of the world economy is now totally dependent on the growth of the U.S. economy, which is dependent on the growth of the stock market, whose growth is dependent on about 50 stocks, half of which have never reported earnings.

Paul Volcker, former Fed chairman, May 14, 1999

The True Menace

Wall Street continues to bask in the belief that the America economy is enjoying a miracle of strong, profitable growth and low inflation. In the last letter, we demonstrated that this extraordinary performance accrues completely from specific statistical adjustments to the measuring of computer investment, which since 1995 heavily pad real GDP growth. During the 12 months through the first quarter of 1999, according to revised figures, computers contributed \$158 billion to a GDP increase of \$290 billion, both measured in chained dollars, implying a computer share of 54%. For comparison, total outlays on computers in current dollar were up a mere \$7.9 billion, equivalent to 1.9% of nominal GDP growth.

In this letter, we extend our critical appraisal of the U.S. economy's performance and underlying fundamentals in the spirit of classical economics. It is obtrusively obvious what has in fact lubricated the American financial and economic boom: not the "Information Revolution" but a revolution of credit excesses the likes of which the world has never before seen. No other postwar recovery has involved financial and economic excesses and imbalances of such preposterous magnitude.

Those GDP statistics are simply ludicrous. A paltry amount of \$7.9 billion actually spent by businesses on computers translates in the calculations of real GDP into an investment boom of \$158 billion (chained dollars). You have to wonder how much higher Europe's and Japan's real GDP growth would be if their statisticians were to measure the spending on information technology in the same fanciful way as their American counterparts.

Mr. Greenspan has successfully prolonged the boom through his three rate cuts, but at the cost of compounding the existing imbalances and financial leverage. The catalyst of the global rally in stock markets has been the perception that numerous countries around the world have aggressively "reflated" and that this will lead to a synchronized global recovery with a revival of inflation. What, indeed, is the true, most serious menace to the global economy?

In short, it is the inevitable bust of the U.S. bubble. It is a historic fact that no serious economic or financial crisis has ever come from tight money and high interest rates. Think of Paul Volcker's Fed rate hike to 20% in January 1981. Nothing is easier then to reverse high interest rates. Every depression, however, has been preceded by very loose money which—through credit excesses—brings about far-reaching economic and financial dislocations.

Proclaiming that "the U.S. is farther ahead than ever," *Business Week* recently reported that, according to the European Information Technology Observatory's latest annual assessment, America boosted its information technology outlays from 4.08% of GNP in 1996 to 4.53% in 1997. Japan weighed in with just 2.61% of its GDP and Western Europe with only 2.34%. Comparing what is spent in different countries on information high tech relative to GDP, we guess that a statistical adjustment toward the American method of measuring computer power, rather than units of computers, would generally add at least one percentage point to their annual real GDP growth.

In Wall Street speak, widely echoed by Mr. Greenspan, this stampede of American businesses into corporate restructuring and high tech has given the U.S. economy a supercharged boost enabling it to grow substantially faster with retreating inflation rates. For the Wall Street bulls it goes without saying that this economic miracle

owes greatly to the new compulsory demand of the financial markets on corporate management to pursue the maximization of shareholder value as the primary measure of operational success.

Like everybody else, we hugely admire the new information technology for its purely technical sophistication, but unlike the Wall Street crowd, we keep wondering how better and better information does, in fact, create higher incomes, higher employment and prosperity.

What Wall Street wants to see, it also manages to see. In the view of the "new paradigmers," U.S. annual productivity growth has surged from less than 1% in the 1980s to 3% - 4% in the last few years. Official statistics showing a rather different picture are simply discarded as badly flawed. Actually, reported annual productivity gains per hour in the economy as a whole were 0.6% in 1995, 2.5% in 1996, 1.2% in 1997 and 2.2% in 1998, hitting a peak of 2.7% in the fourth quarter. For the entire period, it averaged 1.6%. Though up from the miserable 1% of the 1980s, this is still below the productivity gains in most other developed countries, and also considerably below those in the United States during the 1920s, 1950s and 1960s.

BOOM FOR WHOM?

Some time ago, Stephen Roach of Morgan Stanley Dean Witter, one of the few economists on Wall Street who has preserved a critical attitude to the developments in the economy and the markets, addressed the same question in an elaborate essay under the title "The Boom for Whom: Revisiting America's Technology Paradox." He left no doubt that he is more than skeptical that the new technologies of the Information Age truly hold the key to a resumption of faster productivity growth for the nation as a whole.

A boom for whom? That's, indeed, the paramount question. Boom for the limited number of firms which produce computers, or productivity bonanza for the vast number of firms that buy and use the computers in the hope of improving their efficiency? As stated in the official GDP accounts, the U.S. economy has in the last four years endured the greatest investment boom of all times with a fantastic average annual investment ratio of 35% of GDP, measured in "chained" dollars. Such an investment ratio should, indeed, have worked wonders of prosperity and productivity growth. Did it?

As already pointed out in the last letter, America's capital spending is not exactly what the numbers suggest. Most of the investment spending on computers is a measure of spending that never took place. Since 1995, the computer numbers are supposed to reflect the fabulous increases in computational power, rather than much smaller increases in computer units. In the GDP accounts for 1998, again measured in chained dollars, investment spending on computers soared by the stunning amount of $137 billion, as against a paltry increase in actual spending in current dollars by a mere $14 billion, equal to one-tenth of the amount recorded in chained dollars.

When trying to assess the full impact of an investment boom on an economy, it is necessary to distinguish between two different channels: first, investment spending as a source of demand and second investment as a source of supply. The first part concerns the employment and income effects that arise from producing the capital goods that, through the so-called multiplier process, determine total domestic demand growth. The second part concerns the ultimate fruits of the investment spending in the form of overall capacity and productivity growth. For Keynes, by the way, it was the multiplier effects of the investment process on employment and income creation, not the capacity effects, that mattered. With this distinction between short-term multiplier effects and long-term capacity effects in mind, let's examine how the computer boom is, indeed, impacting the U.S. economy.

According to the U.S. capital stock statistics, covering the period 1992-97, the net capital stock of producers of computers and peripheral equipment has skyrocketed by 245% altogether, or at an annual clip of virtually 50%. For other office equipment, the cumulative rise in the net capital stock was an even 319%, with an annual rate of increase of 64%.

In terms of ratio of GDP, this investment boom in new information technology grossly eclipses the investment ratios during the Industrial Revolution. But only on the face of it. For the reasons explained, most

of this boom is a statistical mirage. While computers have been the predominant component of recent investment spending and real GDP growth, they still account for only 2% of the net non-residential capital stock, just as the whole electronic sector accounts for less than 2% of total employment.

TWO CRUCIAL INVESTMENT EFFECTS

Now what are the tangible employment and income effects (multiplier effects!) of the U.S. investment boom in computers on the economy as a whole? In short, they are minimal, and that for an obvious reason: Computer output involves a minimal input of labor and material. To understand the importance of this point, just draw a comparison with the Industrial Revolution. Numerous technological innovations across the whole spectrum of manufacturing and agriculture required massive investment in plant and equipment. Just think of power plants, steel furnaces, railways, etc. These capital expenditures required a heavy input of material, labor and capital, and therefore these innovations had powerful employment and income effects on the economy as a whole. Putting it a bit strongly, it boils down to the difference between producing computer chips and a steel furnace.

Or consider this perspective: Wealth creation in the Industrial Revolution was all about capital formation in tangible, productive assets providing improved efficiencies in tangible production techniques. By contrast, wealth creation in the New Era of the Information Age—or more correctly, perceived wealth creation—is all about a bull market in stocks and exponential growth in computer power.

This leaves us with the second of the two questions listed above. It concerns the efficiency gains in the economy as a whole arising from the massive increase in the use of computers. In essence, this is really what all the hype of the "new paradigm" is about. By making every activity more efficient, the ever-wider use of computers boosts productivity and creates prosperity. So the mantra and the perception. Admittedly, this specific effect is difficult, if not impossible, to measure. But any such gains would essentially reveal themselves in higher productivity growth rates for the economy as a whole.

Indeed, as mentioned earlier, productivity growth has in the last years improved to an annual average rate of 1.6%. That's not a spectacular improvement, but the last two quarters were particularly good. But couldn't this be the beginning of the great miracle that the "new paradigm" crowd is expecting and forecasting? Our answer is a categorical no. What makes us so sure about this? In short, it is the recognition that this apparent improvement in the U.S. economy's productivity growth is an obvious artifact of changes in the way inflation and real growth, in particular the computer component, are measured. Implicitly, the resulting higher GDP growth rates translate into correspondingly higher productivity growth. Statistically, whatever adds to GDP growth adds accordingly to productivity growth.

Boom for whom? We ask once more. America's GNP is ballooning under the impact of the exponential growth in computational power. So what? The queer statistical treatment of computers in the GDP accounts that has been effective in the United States since 1995 is unique in the world.

We can only repeat what we said in the last letter: This way of measuring of computer investment makes no sense. Why, then, do we not measure the output of autos by the increase in horsepower? Because most people would regard it as laughable. What counts from a strictly economic perspective are neither horsepower nor computational power but how much employment and income are created, and the best gauge for that is the actual money spent on computers in the 12 months through the first quarter of 1999: not the $158 billion in phantom chained dollars but $7.9 billion in current dollars. The essential conclusion is that U.S. real GDP growth as well as productivity growth are in this way grossly exaggerated.

TRADE DEFICIT - SIGN OF STRENGTH OR EXCESS?

But how to reconcile this conclusion with the apparently booming U.S. economy? Quite easily, we think. Getting back to basics, what usually overheats an economy is domestic spending in excess of domestic output.

Where the inflationary excess begins depends, of course, on the economy's potential growth rate. According to the "new paradigm" saga, the technology revolution in the last years has raised the U.S. economy's "speed limit" from an annual rate of 2.5% to almost 4%.

Yes, but as we explained in the last letter, this jump in actual and potential growth has virtually come in full from the contribution of the computer producers, as measured in the particular American way (computational power). Ex computers, U.S. real GDP growth remains stuck at around 2%. Given the tight labor market and weak investment in traditional industries, it may even have declined. With vast underutilized capacities in the rest of the world, the U.S. demand excesses have increasingly found their outlet in the surging trade deficit in goods and services, swelling last year to $151.2 billion, after $93.4 billion in the year before. Meanwhile, in the first quarter of 1999, it was running at an annual rate of $198 billion.

It may yet be true, as generally reported, that American manufacturing, too, now has considerable excess capacity in many branches, but it appears that these are mostly in foreign affiliates, not in the plants at home. The obvious fact is that U.S. manufacturing has an extremely unbalanced domestic investment structure. As earlier expounded, capital formation in the high tech sector has been skyrocketing at annual rates of 50% - 60% over the last five years (from a very small base, though), while the net stock of industrial capital equipment has simultaneously (1992-97) proceeded at the sluggish clip of 2.5%. The stock of industrial buildings increased at just a 1% pace. Strikingly, falling capacity utilization is centered in the fast-growing sector of computer and office-equipment makers, lately hitting a level of 75%.

TWO GAUGES OF ECONOMIC HEALTH

A trade deficit signifies that the economy lacks the growth in domestic capacity to accommodate the expanding domestic demand. Overwhelmingly, such deficits arise from credit excesses fueling an immoderate increase in domestic demand. But in the U.S. case, we presume in addition a structural cause: prolonged underinvestment in traditional manufacturing plant and machinery.

The net result of the confluence of these two influences—rampant domestic demand growth and underinvestment in traditional manufacturing—has been that the former is increasingly met by imports. These now account for 31% of the growth in domestic demand for goods, up sharply from 19% when this expansion began in 1991, and more than double the 13% share in 1980.

Under the gold standard and the Bretton Woods System, actually, both policymakers and the markets used to focus on the changes in current account balances as the key gauge of the economy's health and equilibrium. A sequence of poor trade figures quickly brought the currency into trouble, forcing the government and the central bank to tighten their reins. It is, indeed, an established fact that developing spending excesses do show primarily in a deteriorating trade balance, long before they show in rising prices. Until the late 1960,s the beneficial result was a persistently well-balanced world economy with low inflation.

"New paradigmers," including Mr. Greenspan, have spoken of the soaring trade deficit as a function of the U.S. economy's strong growth. The President's Council of Economic Advisers has even claimed that the deficit of the '90s reflects the nation's economic health. Only countries with slow growth have surpluses. Just look at Japan and Europe.

Again and again, the ignorance of even the leading American economists about economic theory and history amazes us. The historical truth is rather the exact opposite. Typically, high-growth economies have had a strong current account balance, while slow-growth economies more often than not have a weak one. In the 1920s, with economic growth higher than today, America had a substantial, chronic trade surplus. And so did Japan and Germany in past times, when their economies still used to boom. The common feature behind this concurrence is a high level of domestic savings.

As to the present U.S. trade deficit, it is evidently the function of two major maladjustments in the U.S. economy: insufficient domestic manufacturing investment outside of high tech, on the one hand, and the collapse of personal savings, on the other. Let's formulate it like this: Where there is *healthy*, strong economy growth, there is inherently a high savings ratio and consequently a trade surplus.

DOLLAR STRENGTH THROUGH CARRY TRADE

Essentially, a current account deficit has a flip side: a capital account surplus. In 1998, the United States ran a deficit in current account of $233 billion, up from $155.2 billion in 1997.

On top of it, there were capital outflows of $305 billion. All this spending abroad on current and capital account essentially required coverage through capital inflows from abroad. The rising dollar indicated that this huge dollar outflow was more than matched by capital inflows from abroad, amounting last year altogether to $542 billion. The bulk of this money came through the equity market ($196 billion, including exceptionally large foreign acquisitions of U.S. compositions) and the bond market ($265 billion), after even $343 billion in the year before.

Our critical eye is specifically on the inflows from abroad into the U.S. bond market. It is an open secret that they contain a very large segment of purchases not from foreign investors but from American offshore funds heavily engaged in dicey "carry trade." That is, they play the big spread between high-yielding U.S. bonds and much lower short-term rates of certain foreign currencies. As the proceeds from such loans are converted into dollars and invested in medium or short-term U.S. paper these operations boost the dollar and depress the borrowing currency. Though nobody knows how big the positions actually are, they certainly run into several hundred billions of dollars. Definitely, they are taking place at a scale that has made them the key determinant of the dollar rate against yen, Swiss francs and the euro.

International carry trade involves two separate risks. The one are losses on the asset holdings, and the other one is any rise in the borrowed low-cost currency. Given the high degree of leverage employed, any minor adverse changes in one of the two is apt to induce heavy, cumulative unwinding of such positions with potentially dramatic currency effects. This was vividly demonstrated last autumn, when various events, primarily the Russian debt moratorium and the Fed's three rate cuts, raised concern about the dollar. Against this background, the dollar suffered between late August and early October two waves of historically unprecedented steep declines against the yen from Y143 to Y114 and against the mark from DM1.81 to DM1.61.

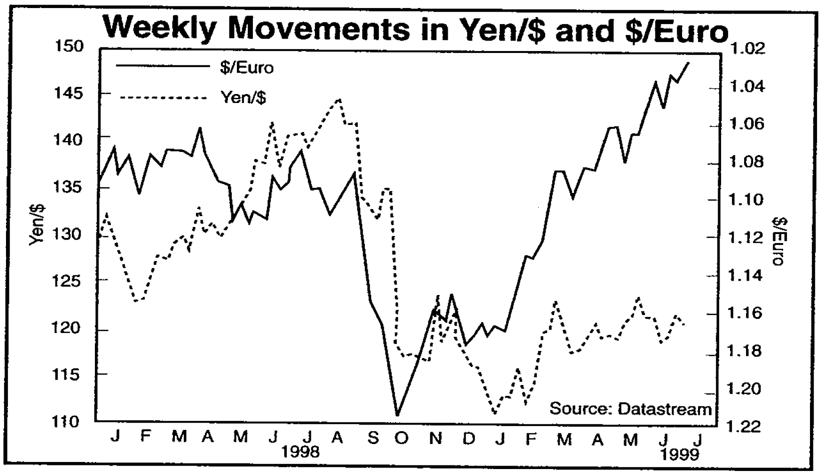
For the currency of an economy enjoying extraordinary new paradigm qualities, this was quite a plunge in the span of barely five weeks. Massive unwinding of yen carry trades chiefly precipitated this virtual dollar collapse. Its primary trigger was the losses on U.S. bond holdings in the in the wake of the Russian crisis. As the existing heavy leverage turned a moderate rise in yields into big losses, margin calls forced many of these traders to close their yen carry trade positions, involving surging demand of yen against dollars. As the dollar plunged and the Japanese and the European currencies soared, the former dollar optimism cracked. Within a few weeks, growing fears of a continuing dollar decline kindled a second wave of unwinding carry trade positions with the effect of another sharp fall of the dollar.

Considering the enormous scale of international carry trade during the last three to four years, it is clear that it must have caused tremendous distortions in bond and currency markets. Carry trade has, for sure, been the main source of strength both of the U.S. dollar and the British pound. There is great amazement in the markets about the resilience of the pound against the backdrop of falling interest rates and a soaring British trade deficit. But declining bond yields in a recipient country of carry trade, promising capital gains on the bond holdings, attract carry trade, while rising yields drive it away. Paradoxically, if the Bank of England wants a weaker pound, it ought to do something that raises bond yields. Just look at the United States, where the rise in bond

yields have failed to strengthen the dollar. Principally, this is a repeat of what occurred in September/October of last year.

EURO MISERY

The euro had a miserable opening. The message markets continue to get is that there's an utter lack of agreement on how to handle the euro's plight. We have for many reasons never been a friend of the euro. But our misgivings were more about the politicians than about the currency So far, we see our bad premonitions fully confirmed. Rather than reassuring people and investors, their declarations only validate fears that European policymakers are in denial about the euro's woes. The greatest disappointment for us is Mr. Duisenberg, the president of the European Central Bank. He has badly distinguished himself with recurrent contradictory remarks, and above all with repeated explicit statements that he does not care about the falling euro. In this respect, though, he had a lot of company among officials in Europe. Considering also the abrupt cut in the euro interest rate by 0.5%, policymakers in Europe have virtually solicited speculation against the euro, and the markets, always in frantic quest of the next possible killing, have readily obliged.



Almost daily, currency gurus have been trotting out the litany of explanations of why Europe's new currency is so sick. Slow growth and low interest rates in Europe do, in fact, contrast dismally with fast growth and rising interest rates in the United States. All this seemingly reinforces the perception that the U.S. miracle is intact, while the euro-zone is stuck with intractable structural problems.

Our own investigations tell us that this prevailing, glorious perception of the U.S. economy is absolutely ill-founded. First of all, as explained, real GDP growth is hugely overstated through the computer component. Second, it is unmistakably a bubble economy. One single point is undeniable: America has a marvelous record in creating jobs. Yes, but that has been happening now for 50 years.

As to the above chart, we draw attention to two remarkable facts: first, the mighty dollar is extremely weak against the yen; and second, the dollar's strength against the euro largely reflects a recovery from its steep decline during last fall's financial crisis. Before that crisis, the DM/dollar rate was 1.81. Today, it is 1.88. The great volatility is clearly in the dollar.

It is a safe assumption that this volatility is chiefly due to large-scale shifts in the international carry trade. Above all, a progressive switch in carry trade borrowing from yen to euro has been undermining the latter. As a result, yen and euro went diametrically opposite ways. To this trade there are two keys: the interest rate differential and the performance of the currency in which the borrowing is done. While the dollar's interest spread against the euro is much smaller than against the yen, the greater lure has been the expectation of bigger gains on the plunging currency, which the carry traders, of course, precipitated. Not by accident, the General Manager of the Bank for International Settlements in Basle, Andrew Crockett, at a recent press conference warned the carry traders against exploiting the euro's current weakness for their heavily leveraged purchases of higher-yielding dollar bonds, recalling the disastrous currency effects of the large-scale unwinding of yen carry trade last autumn.

In the consensus perception, the dollar is a fundamentally strong currency reflecting the exceptional strength

of the economy. We vehemently object. First of all, we see the deceptive strength of a highly vulnerable bubble economy, and second, we see a currency that is artificially boosted by carry trade. Just consider the dollar's virtual collapse last fall. In particular against yen which virtually bears no interest. Meanwhile, it needs repeated massive interventions by the Bank of Japan to pare a further fall of the dollar. Why? Because the yen carry trade has blown up for various reasons.

THE GREAT AMERICAN WEDGE

Clearly, the U.S. economy is booming. But what exactly is booming? Is it the economy's demand side or the supply side? And what is the main driving force behind it? Is it high tech, or what else? Hopefully, we have clarified that the GDP statistics in "chained" dollars give a grossly exaggerated picture of the rate at which the U.S. economy is growing.

Definitely red-hot is consumer demand, especially two credit-driven components: durable goods and residential real estate. But the spending binge on durable goods is largely diverted into soaring imports, while the housing bubble has gone heavily into house prices. Since neither of the two effects enters the consumer price index, Mr. Greenspan and others happily proclaim that there is no trace of inflation.

Leaving aside the exotic computer statistics, profligate consumer spending is plainly the overriding bubble component in the U.S. economy. Just as plainly, it is fueled by profligate consumer borrowing which, in turn, is crucially aided and abetted by the profligate wealth effects generated by the booming stock market. Conventionally, an economy ranks as "bubble economy," when soaring asset prices substantially impact the economy through correlated credit excesses. While such bubble effects in Japan were concentrated upon industrial investment and commercial construction, they display in the U.S. case overwhelmingly in consumer spending.

With negative personal savings, a soaring trade deficit and low productivity growth, the U.S. economy has definitely the lousiest economic fundamentals among the major industrial countries. However, there is one specific feature, in which it beats any other country in the world, and that is in reckless and boundless credit creation. In the light of a literal credit explosion, all the talk that the U.S. economy's strong growth is driven by high tech, restructuring, downsizing, labor flexibility or any other magic appears completely ridiculous. For anyone with eyes to see, the U.S. economy's true "new paradigm" is unprecedented, runaway consumer borrowing.

While U.S. nominal GDP grew $400 billion last year, net new borrowing by businesses and consumers ran at $952 billion. On top of this, the financial sector borrowed $1,116 billion, the two adding up to $2,090 billion. Note that each dollar added to GDP was financed by incurring $2.38 added to non-financial debt and further $2.79 added to financial debt. Consumer borrowing, specifically, was up $486 billion. Comparing this ludicrous credit expansion in 1998 with GDP growth of $400 billion in current dollars, we no longer wonder why the U.S. economy has grown so much. If there is a puzzle, it is actually over why with this runaway credit expansion the American economy, less computer output, has not delivered faster growth than just the 2%.

Principally, there is but one possible explanation: supply constraint. This presumption is in keeping with our argument that net equipment investment as a ratio of GDP—also without computers—has been near its lowest level in the whole postwar period in the present U.S. economic recovery. In connection with a tight labor market, there is simply no scope for higher economic growth.

Viewing credit excesses as the mother of every economic crisis, we always keep a critical eye on the size of credit flows and their specific use. As to magnitude, the present U.S. credit deluge is, without question, the worst ever in history, taking the negative savings into account. The credit deluge has riddled the U.S. economy with unsustainable excesses and imbalances, but it had little or no effect on the inflation rate. More than anything

else, the benign inflation picture is for the "new paradigmers" the compelling proof that the U.S. economy has, indeed, undergone a miraculous transformation towards higher non-inflationary growth.

Nonsense. In reality, this unaccustomed and greatly hailed absence of inflation has a number of obvious reasons. Most important and also most conspicuous is the fact that the extraordinary credit excesses have proliferated overwhelmingly through the financial markets, fueling rampant inflation there. Remember that corporations, financing stock buybacks, mergers and acquisitions, poured a net $262 billions of borrowed money into the stock market last year.

The second obvious, major reason for subdued inflation in the United States is that the soaring trade deficit and the real estate bubble acted as great absorbers of inflation. Few people, moreover, seem to be aware that the trade deficit is driving an ever bigger wedge between the U.S. economy's credit-driven booming demand side and a badly lagging supply side. This wedge shows most spectacularly in the rapidly widening gap between soaring retail sales—up almost 8% in the twelve months to May—and the sluggish growth in industrial production, up a mere 1.7%. Booming demand is mistaken for a booming economy.

HOW SICK IS EUROPE?

Neither do we share the conventional view that Euroland, and in particular Germany, owe their present growth problems chiefly to lacking deregulation in different spheres, especially in the labor markets. The need for more employment flexibility and a trimming of the lavish welfare state cannot be questioned. Nonetheless, Europe, Germany or Japan could tomorrow have the same high economic growth as America, if consumers would do as their American counterparts have: slash their savings. Fortunately or unfortunately, European lifestyle, moral attitudes and more conservative bankers stand in the way. Economic growth through massive dissaving is, in any case, nothing to be proud of.

What Japan, German and many other countries presently have in common, and what is primarily restraining their economic growth, are vast domestic savings but insufficient credit creation to fill the substantial demand and output gap that arises in their economies from the high rates of personal savings. Their credit machines have faltered. Why? That's the key question to be examined.

In the last analysis, this is a structural problem. Traditional outstanding features of these economies are high savings and investment ratios which in the past provided the high productivity gains and low inflation rates that used to distinguish these countries from the inflation-prone American economy. Investment and export-led growth is their inherited pattern of economic growth. In accordance with this intrinsic economic structure, their credit machines are traditionally geared to finance business investment, residential building and exports. Consumer credit was and still is grossly underdeveloped compared to the United States.

With excess capacity prevailing worldwide, investment spending and exports have drastically lost momentum around the world. Essentially, this has hit most strongly those economies harnessed to this pattern of growth. Consumer-led economic growth is trumps, essentially favoring the countries with a customarily high propensity towards consumer borrowing. These are mainly the English-speaking countries, America in the first place. Unique to this group of countries is that the enormous wealth gains on equities and houses have been transformed into a fantastic consumer borrowing and spending binge which has offset, or more than offset, the drag from shrinking net exports. Knowing a bit about the essence of long-term growth fundamentals, we have some difficulties to hail this development as "new paradigm" health.

It is in particular these considerations that have led us long ago to expect prolonged subdued economic growth and inflation in all these high-savings countries. Europe's advantage is that it has avoided the bubble excesses that have devastated the economies of Japan and Southeast Asia. For us, this is a most important aspect concerning Europe. There is less growth than in the U.S. bubble economy, but there is far greater stability in the economies and the financial system.

UNITED STATES: ON TRACK FOR NEW DEBT RECORDS

In the last letter, we noted that bank lending and broad money growth in the United States had drastically declined. Forget it. Recently released data from the Federal Reserve reveal new records in borrowing and lending. Other credit sources than banks poured forth all the more abundantly. Total credit, non-financial and financial, expanded in the first quarter at an annualized rate of $2.2 trillion, a new record, up 20% against 1998's first quarter and up 120% against 1997.

In a continuation of last year's second half free-for-all, borrowing and lending by the financial sector again led the credit melee with an increase by $1.2 trillion. Comparing this amount to the $457 billion borrowed and lent by the financial sector in 1995, one can appreciate the exponential character of the current credit expansion

Of the $1.2 trillion annualized financial sector credit growth, just $33 billion, or 3%, came in the first quarter from the commercial banks, after 15% in 1998 and 25% in 1995. At the same time, non-bank lending by the combination of GSE's (Fannie Mae, Freddy Mac and Federal Home Loan Bank System), mortgage security pools and asset-backed securities went from 28% to 45% if total credit growth. An important thing to be taken note of in the light of these figures is that the broad money supply figures—reflecting only bank credit growth—have clearly lost any usefulness as monetary indicator.

In the non-financial sector, business debts rose $391 billion at an annual rate, almost one third more than in the year before. The consumer incurred new debts at an annual rate of $556 billion, or 26% more than last year. His favorite vehicle is mortgage borrowing, adding $411 billion at annual rate, compared to $360 billion for all of 1998 and $230 billion in 1997.

But the king in unfettered credit creation is now investment banking, using the securities markets as its source of finance. Corporations issued $161 billion of securities, up 48% from a year before and up 86% from 1997. Significantly, most of the new borrowing was from overzealous financial corporations. Everything, however, pales beside the exploding issuance of securities by the Federally related agencies. During the first quarter, they issued an annualized $563 billion of securities, compared to $473 billion in 1998 and $213 billion in 1997. In fact, their issuance of securities in one quarter equaled 76% of their total 1997 issuance.

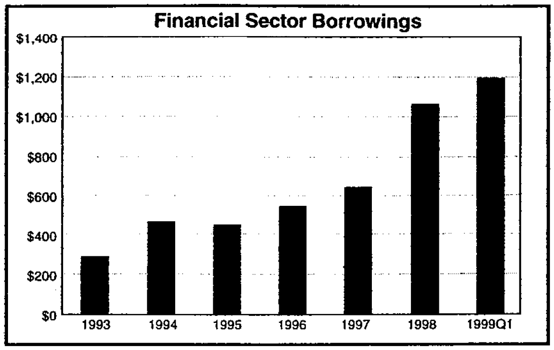
Unbelievably, in the whole discussion about the U.S. economy, there is nary a word about the surfeit of credit creation outside of the banking system flooding the economy and the markets. Even Mr. Greenspan has never made any reference to it. There is systematic, complete neglect of this subject, and we think, one reason for this is general ignorance about the way, how credit is created and how it impacts the economies and the markets. Implicitly, this makes these observers absolutely blind to the extreme excesses in this area.

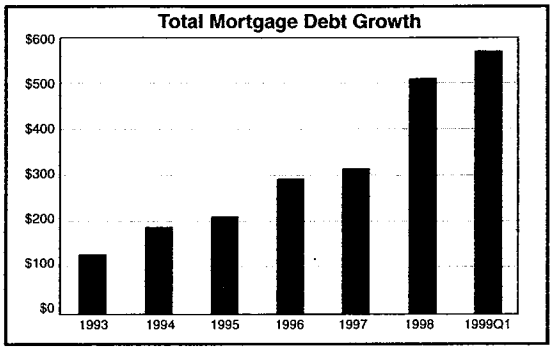
HOUSE PARTY

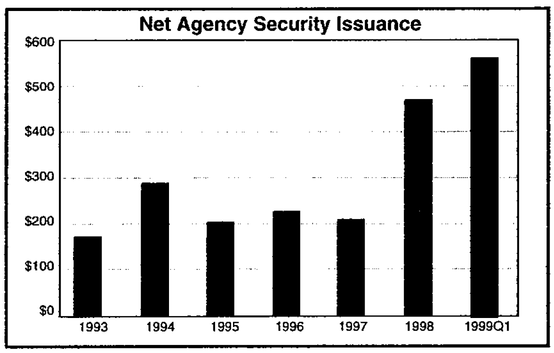
The frenzied bull market in shares has diverted attention from the traditional indicator of irrational exuberance, a booming housing market. What's more, mortgage finance is at the heart of the domestic credit glut involving the consumer. Looking at the unbelievable figures, one is tempted to say the American public is monetizing their family homes.

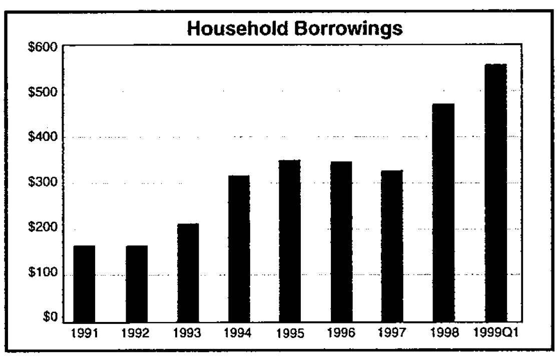
Houses are the most convenient vehicle for consumer borrowing. During the first quarter of 1999, total mortgage credit grew at an annualized rate of $576 billion. To put this number in perspective this amount compares with an increase in residential building, year-over-year, of about $40 billion. Credit expansion in the quarter was 20% greater than in 1998's first quarter and 82% greater than total mortgage growth in 1997.

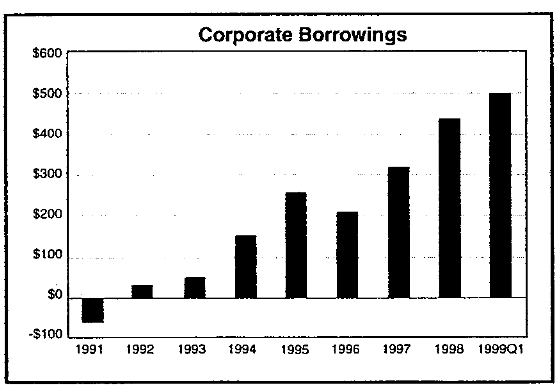
During May, stronger than expected housing starts increased more than 6% from April. Compared to last May, starts were 8% higher and actually 17% higher than in May 1997. The key single-family residence component surged almost 13% to an all-time record. Even more convincing proof of a developing boom/bubble in the real estate markets came with the release of April new home sales. For single-family homes, they jumped 9.2% from March to











an annual rate of 978,000, just below November's record. So far this year, new home sales are easily on pace to break last year's record.

A recent article in the *American Banker* stated that home prices throughout California have risen almost 10% over the last 12 months, a bit faster than that in Southern California and a bit less in the north. It is estimated that California homes are now appreciating about $15 billion per month, or more than $2,100 per month for each home in the state. Home prices have surged more than 20% in the past 18 months in San Francisco and the Greater Bay Area, including, of course, Silicon Valley.

Even Mr. Greenspan has recently taken notice: "There's been a pronounced impact on consumption expenditures as a consequence of the normal turnover of existing houses. The home sales market is a critical factor of what's going on in retail sales." He continued, stating: "On the sale of a home you tend to realize very large capital gains—on average, that has been in excess of $35,000. When you are talking about 4 million sales, that's a very large number." Doing the calculation for Mr. Greenspan, but using the current resales rate of 5 million, this is $175 billion of recognized gains in one year that become available to spend on consumption or play the stock market. Include the untold billions of cash created from mortgage refinancings and home-equity lending, and one is clearly at the epicenter of the explosion of credit.

In short, with overabundant use of mortgage finance countless American households have created a singular, historic windfall of purchasing power that has fueled the consumer spending boom and has as well provided the excess liquidity to stoke the stock market mania. An indispensable counterpart to these unprecedented credit excesses is an overexpanded and overzealous financial superstructure that is absolutely unfettered in creating credit beyond all bounds. We must admit to have grossly underestimated this component of the American bubble. It has removed any lingering doubts that is by far the greatest and the worst credit bubble that the world has even seen.

...AT THE EDGE

"At what interest-rate setting do you create the degree of liquidity which has the highest probability of sustaining the expansion into the future?" This, according to a remark by Mr. Greenspan in a recent congressional testimony, has become the fundamental question that today determines Federal Reserve policy. With this in mind, there should be no mystery as to why such talk prompted a big rally in both the credit and the equity market. The markets, understandably, rejoiced at a Mr. Greenspan intimating his intention not to hurt the economy and the markets. With his credibility on the line, however, he is forced to take back

some of his rate cuts last fall. At the same time, he assures the markets that he will at all times provide the necessary liquidity. But considering his ebullient view of the economy's health and strength, we can only wonder what makes him so extremely cautious of carrying out even a minuscule rate hike.

Well, the Fed chairman has surely recognized that the U.S. financial system today hangs in an increasingly precarious position, a house of cards literally built on nothing but financial leverage, speculation and derivatives. Untold trillions of dollars of securities are held by highly leveraged institutions having borrowed from the money market. And, significantly, since last fall's near meltdown, precipitating Mr. Greenspan's hasty rate cuts, more than $1 trillion of additional debt has been loaded on an already vulnerable and overleveraged financial system, including more than $200 billion of asset-backed and $600 billion of mortgage-backed securities. In short, the credit bubble was allowed to take a decided turn for the worse.

Repeating ourself, we emphasize once more a point that is most important, although, in general, overlooked. It is the fact that the recent credit excesses have overwhelmingly emanated from Wall Street security issuance. With yields on five-year Treasuries approaching 6% and on long-bonds 6.25%, an almost 150 basis points rise so far this year, virtually all of the past 12 month's record security issuance is now under water. This takes on particular significance in the present environment where leveraged players have become the primary market players for much of the new security issuance. Given negative personal savings, the market depends totally on leveraging. But since securities, as opposed to bank loans, are generally marked to market on a daily basis, the credit system becomes highly sensitive to changes in rates, as higher rates lead to forced selling by the leveraged players that have little cushion for loss. Given the existing monstrous extent of leveraging, a rapid rise in interest rates is prone to put the whole financial system in jeopardy.

Here, the key point to recognize is that a recklessly leveraged financial system is acutely vulnerable to fleeting shifts in market perceptions about interest rates, currencies or economic performance. The greater the leverage, the more tenuous become market underpinnings. The larger the exposure of the financial system to positions marked to market, the greater the risk of a sudden and unpredictable massive disappearance of liquidity. Having gone to ever greater excess, the dangerously leveraged U.S. financial system is more than ever predisposed to a savage liquidity crisis. In question is only the trigger that will finally prick the bubble.

FORGET INFLATION

Appraising the global economic and financial development over the last years, what should we look upon as the predominant danger beyond the short run: inflation or deflation? Our peremptory answer is that generalized resurgence of inflation is virtually impossible. Forget inflation. The true and greatest menace to the world economy is not that an overheating U.S. economy will spill inflation over to the rest of the world, but that the U.S. financial and economic bubble will burst with a collapse of the dollar in its wake. That nightmare would occur if the U.S. private sector should restrain its excess spending while the European and the Japanese economy remain too weak to absorb the blow.

In our opinion, the postwar era of strong economic growth and strong cyclical fluctuations among the industrial countries has once and for all ended. The new global long-term pattern will, at best, be both subdued economic growth associated with a virtual absence of inflation. What has principally led us to this conclusion are our previous reflections about the present chasm in the world economy between lingering investment-led economies and booming consumer-led economies. Essentially, the final outcome will depend crucially on whether the laggards will follow the leaders or vice versa.

To the first group—the high-savings and high-investment economies—belong Japan, Southeast Asia and Continental Europe. The development of investment bubbles and their later bursts, first in Japan, then in Southeast Asia, have thrown the Asian economies badly out of kilter. Continental Europe has not indulged in such investment excesses, but its economic growth depends heavily on the continuation of strong investment

spending at home and around the world, but that is definitely not on the cards for the foreseeable future. Since personal savings are sure to stay on the high side, there is little or no chance that these countries will resume their former strong economic growth. They will remain stuck with subdued growth and disinflation, if not deflation.

All eyes are on the American consumer as the world's top borrower and spender. We have to admit that we have grossly underestimated his willingness and ability to overspend. What we regarded as already unsustainable excess went to ever greater excess. Yet this doesn't invalidate the truism that all bubbles burst, and that the bigger the bubble the worse the burst.

At issue really is whether the American boom might possibly spill over into inflation of goods and services, or whether it is intrinsically destined to end in painful deflation. To this question our unequivocal answer is: Never in history has inflation in financial assets led to inflation in the prices of goods, services and tangible assets but always to hard deflation. And this is so not by chance but by compulsion because every asset inflation involves a leveraged flight out of cash and into financial assets. While a boom always involves heavy credit creation, a general flight back out of assets and into liquidity has only one effect: it spreads general illiquidity.

CONCLUSIONS:

In the first place, we emphatically stress that U.S. real GDP and productivity growth are grossly exaggerated through the peculiar way of how the output of computer makers is measured in chained dollar. The U.S. "new paradigm" economy is a statistical fabrication.

The main economic query for 1999-2000 does not concern the euro. It does not even concern Japan or the emerging economies. It concerns the U.S. economy. Will it stay strong, or will the bubble burst? What happens in the United States is make-or-break for the world economy and global stock market this year and next.

Mr. Greenspan did precisely what was most prone to minimize any effect of his move and to give the financial markets a new shot of exuberance. While just slightly tapping on the monetary brake, he assured the markets that no more of this kind was to follow, and the markets rallied in relief. For sure, there is zero credit tightening.

The U.S. credit bubble is getting more and more pompous, but its effects are diminishing. Rising stock indices make the headlines, but the breadth of the market continues down. There comes a critical point, where the most rampant credit creation is no longer enough to keep the economy and the markets booming. Just consider that more than half of current U.S. real GDP growth now comes from the computer makers.

The underlying trend of the global economy is basically deflationary. Fears of inflation are misplaced. The true menace for the U.S. economy and the global economy is the inevitable bursting of the U.S. bubble.

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